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***JOBS for Kentucky* fulfills Governor Fletcher’s promise to enable families to keep more of the money they earn, relieve the burden on low-income families and help Kentuckians better afford important programs and services such as post-secondary education and health insurance.**

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***JOBS for Kentucky* modernizes a tax system that was not fair, not reliable and not good for growth. It will improve economic development by removing onerous taxes on investment and accounts receivable, as well as widening the tax base and lowering tax rates. In addition, closing loopholes will make it more difficult for corporations to shift profits out of state.**

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June 2005

To the People of Kentucky:

After decades of studies and failed attempts to update our tax code, Kentucky successfully achieved the goal of modernizing the system through changes that will broaden the tax base and lower tax rates. The result: income tax relief for most citizens who pay taxes and more revenue stability for government to continue providing important services to Kentuckians.

The *JOBS for Kentucky* tax modernization plan will boost Kentucky's economy, stimulate more investment, build and sustain better careers, and create more opportunities for job creation for our Kentucky families.

It is proof that bipartisan efforts and cooperation between branches of government can lead to important achievements for our Commonwealth.

Strengthening Our Families

It is a historic achievement for families because:

- ◆ If you work and live in Kentucky, your income taxes are likely going down, allowing you to keep more of what you earn. In addition, *JOBS for Kentucky* removes almost 500,000 low-income family members from the income tax rolls.
- ◆ If you have a child in college, for the first time ever you will be able to get a state tax credit of up to 500 dollars if that child goes to a public or private college in Kentucky.

Strengthening Our Economy

In addition to the benefits of a productive work force and low-cost energy, Kentucky will have a new economic development approach to attract investment because antiquated and unfair tax laws that are almost 100 years old have finally been

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repealed. That means *JOBS for Kentucky* will increase jobs and opportunity as well as investment in our Commonwealth.

JOBS for Kentucky repeals the corporate license tax and reduces the top rate of corporate income tax by 27 percent. The tax burden on Kentucky-based companies will finally be competitive with surrounding states — creating the opportunity for those companies to grow, create more jobs and strengthen our economy.

Under the old tax code, a company had to be located in designated areas of the state to receive certain tax incentives to start or expand a business. Under *JOBS for Kentucky*, companies can now receive a refund of taxes on building materials regardless of location. This incentive also applies to research and development equipment purchases, which will benefit technology-based start-up firms.

Strengthening Our Communities

Communities will benefit from the 10,000 new jobs estimated to result from the full implementation of tax modernization.

If you have an old, historic home that needs attention or have an opportunity to reclaim an industrial site, *JOBS for Kentucky* will help you. Incentives for redevelopment of abandoned industrial sites, historic preservation, horse breeders and environmental efforts will bolster, strengthen and preserve the unique heritage of our Commonwealth.

Strengthening Our Future

JOBS for Kentucky, strong fiscal management and an improving economy enable us to make strong commitments to education, economic development and technology — key priorities for our future.

When I ran for Governor, I made a commitment to address Kentucky's failing tax system to restore hope and opportunity and strengthen our economy. I am pleased that the General Assembly agreed with that commitment as evidenced by the overwhelming margin of passage of this historic legislation: 37 "yes" votes and zero "no" votes in the Senate, and 96 "yes" votes with only 3 "no" votes in the House. I am proud to report to you that a promise made is a promise kept.

Sincerely,



Governor Ernie Fletcher

Executive Summary

Many states have attempted to reform their tax codes but few have succeeded. In Kentucky, several studies and failed attempts at tax modernization were undertaken in the last decade before Governor Ernie Fletcher's *JOBS for Kentucky* was enacted in March 2005.

Likewise, it is rare in recent years for a state to cut income taxes as Kentucky has done. Governor Fletcher's tax modernization program was nearly unique among the nation's fifty states in achieving a broad based reduction in the rate of individual income taxes.

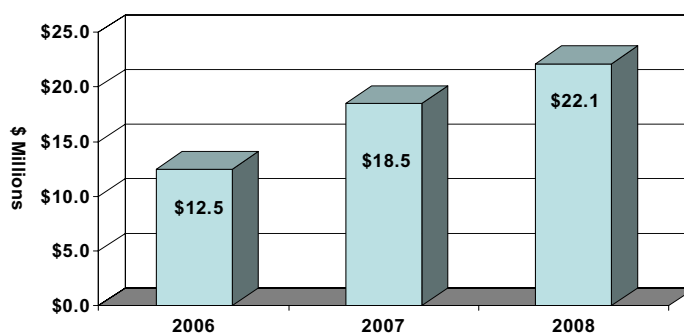
In the period following the recession of 2001-2002, only one other state (Montana) has moved its income tax rates downward. Four other states (Idaho, Massachusetts, Oklahoma and Rhode Island) reduced their income tax rates earlier in this century.

Meanwhile, seven states (Arkansas, California, Connecticut, Massachusetts, New York, North Carolina, and Oregon) have either increased top marginal rates or suspended credits or planned reductions in rates in response to declining revenues in recent years.

Indeed, over the last four years, the combined impact of income tax increases among the fifty states exceeded the impact of the cuts by a ratio of about 3 to 1.

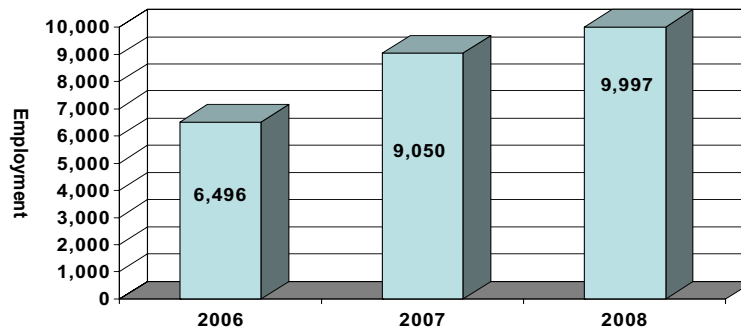
It is even more uncommon that a revenue-neutral tax modernization package would produce a strong economic stimulus, but that is what *JOBS for Kentucky* has accomplished. As shown in Figures 1 and 2, by the first full year of implementation in fiscal year 2008, there will be almost 10,000 new jobs and \$22 million of additional revenue as a result of tax modernization.

Figure 1
Estimated Dynamic Revenue Impact



Source: Office of State Budget Director

Figure 2
Estimated Additional Jobs



Source: Office of State Budget Director

JOBS for Kentucky has achieved the creation of a tax system that is fair, reliable and good for economic growth. It has repealed tax laws that were antiquated and unconstitutional.

In addition, by broadening the tax base, lowering tax rates, taxing similar companies fairly and closing loopholes, *JOBS for Kentucky* will reduce the ability of companies to shift profits out of state and level the playing field for Kentucky companies.

Experts agree that the following changes will provide the most economic stimulus by removing barriers to job growth and investment as well as making Kentucky more competitive with surrounding states:

- The repeal of the 1906 corporate license tax, which is a tax on capital that also was ruled unconstitutional;
- The reduction of the corporate income tax rate from 8.25 percent to 6 percent, which will be accomplished in two phases;
- The repeal of the intangible property tax, which primarily taxed accounts receivable; and
- A reduction in the individual income tax from 6 percent to 5.8 percent for income between \$8,000 and \$75,000.

The changes will create opportunities for more citizens to find work and keep a larger percentage of what they earn. At the same time, *JOBS for Kentucky* will provide a stable revenue source so Kentucky can mitigate the impact of past unreliability, which resulted in \$1 billion in unanticipated, mid-year budget cuts over the last four years.

Strengthening Families

Individual income tax reductions

The cornerstone of the proposal is to decrease the individual income tax burden on working Kentuckians.

This was accomplished by lowering the top marginal income tax rate on income less than \$75,000 and reducing the tax burden on the lowest-income Kentuckians. All of Kentucky will reap the long-term benefits as the lower rate keeps Kentucky competitive.

To address the disincentives created by a high top marginal rate, the enacted legislation decreases the existing top rate of 6 percent to 5.8 percent for all taxpayers on income up to \$75,000 annually (up to \$150,000 for a married couple filing separately on the same return). More than one million households will see an income tax reduction.

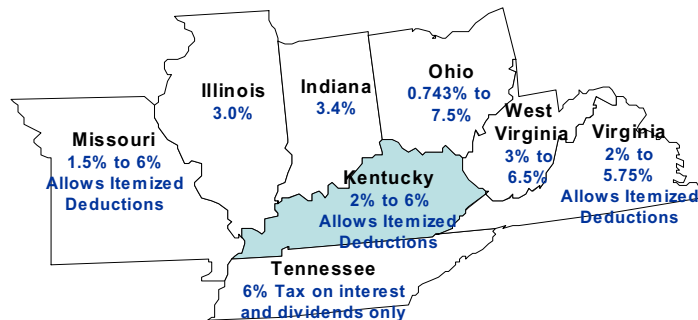
This is true because it is not just the wealthy who have paid the top income tax rate. The top rate of 6 percent was set in 1950 and applied to all income over \$8,000. If the threshold for the top bracket were adjusted for inflation, the top rate would instead apply to income in excess of \$62,400.

Willingness to make this level of financial commitment to lowering tax rates underscores the importance of economic competitiveness to the Fletcher initiative. It sends a strong signal to the business community that Kentucky is an ideal location for future growth and expansion, and it will provide immediate relief to low-income Kentuckians.

Kentucky's income tax structure has not been conducive to the attraction of human capital. With a reduction in the top tax rate for most Kentuckians, Kentucky will become more competitive in this arena. Figure 3 reflects Kentucky's position relative to surrounding states regarding individual income tax rates.

Because *JOBS for Kentucky* removes obstacles to expansion and growth, the dynamic scoring model forecasts growth in the overall tax base in future years. By lowering income taxes for most Kentuckians, this plan will make Kentucky more competitive.

Figure 3
**Individual Income Tax Rates for
 Surrounding States**



Source: Commerce Clearing House, Inc.

Credit allowed for tax paid by certain owned business entities

JOBS for Kentucky provides an individual income tax credit for Kentucky tax filers who own businesses that are organized as limited liability entities (pass-through entities) because tax modernization will shift those obligations to the business entity level.

Individual owners of a limited liability entity currently are taxed on that entity's income, but they pay that obligation as part of their individual income tax. Until now, the entity itself paid no tax on that income.

Limited liability businesses will now pay the corporation income tax at the entity level. This legislation also allows a credit to the individual for their proportionate share of that entity level tax. The credit is limited to the amount of tax the individual would have paid on the income that is passed through to the individual.

Expanded low-income tax credit

In the past, Kentucky has made the short list of states with the most onerous income tax on the working poor.

A 2001 study by the Kentucky Legislative Research Commission found that Kentucky's individual income tax burden on families in the lowest-income quintile ranked 10th highest among the states and 12th highest for families in the second-lowest income quintile.¹

¹Legislative Research Commission staff memorandum. September 28, 2001. Comparison of state and local tax burdens and government benefits for low-income families. p.11, 13.

To further address the needs of low-income families, *JOBS for Kentucky* included a significant expansion of the low-income credit, effectively removing the income tax burden on filers with incomes below the federal poverty level.

The adjustments to the low-income credit will give significant relief to lower-income Kentuckians. In 2004, a family of four whose income was \$18,000 owed as much as \$586 in tax. This legislation reduces that family's income tax liability to zero.

The new law provides that a taxpayer whose income is at or below the federal poverty level will owe no state income tax. A family of two at the federal poverty level will save up to \$312. Because federal poverty levels are adjusted each year for inflation, *JOBS for Kentucky* will automatically ensure that in the future these individuals who fall into or remain in poverty will not be punished by increases in the cost of living.

As a result, more than 216,000 filers representing approximately 496,000 Kentuckians will no longer owe any state income tax.

Extending the credit will offer relief to taxpayers with incomes up to 133 percent of the poverty level. Approximately 306,000 additional lower-income filers will see decreases in tax liability.

In addition, to ensure that the benefit of the low-income credit is targeted toward the neediest, the new law redefines the income base for qualification of the credit to include retirement income. Currently, a couple with retirement income up to \$80,000 benefits from the low-income credit if their non-retirement earnings are below \$25,000. The credit was never intended to benefit taxpayers with income more than \$100,000, and tax modernization fixes that.

Lift the burden of college tuition

The difference in lifetime earnings between a worker with a high school diploma and one with a college degree is more than \$1 million. Meanwhile, tuition and other expenses at institutions of higher learning have increased significantly in recent years.

On a national level, the federal government has sought to lessen the impact of these increasing expenses by implementing several credits and deductions that may be claimed on an individual's income tax return.

To help Kentucky families combat these higher costs, *JOBS for Kentucky* establishes a companion credit on the Kentucky income

tax return equal to 25 percent of the eligible federal Hope and Lifetime Learning credits. Kentucky already uses this approach for the child-care tax credit.

The credit will help families cope with the rising costs of tuition for colleges, universities and technical colleges. It is estimated that more than 61,000 families will be able to use the credits, providing a maximum benefit of \$500² per student per year. The federal credit is a function of tuition paid, so scholarships, grants and other financial aid discount the average available credit. The average Kentucky taxpayer who qualifies for the federal credit will receive a Kentucky credit of approximately \$262.

Specifically, the credit:

- Applies only to undergraduate students;
- Phases-out for high incomes (completely phases out at more than \$105,000 of modified adjusted gross income for joint filers);
- Is nonrefundable, but may be carried forward into future years; and
- Applies when students attend private or public colleges, universities or technical colleges within Kentucky.

Taxpayer qualification for the credit is already determined by the IRS, so no significant additional taxpayer effort will be required. Neither the Kentucky credit nor the federal credit is refundable. However, the Kentucky credit may be carried forward for five years and used to offset future tax years' liability.

In addition, the Kentucky version of the credit will provide additional relief to low-income workers who pursue post-secondary education opportunities since the credit will extend the threshold level of income that remains untaxed in Kentucky.

²\$500 maximum is a function of existing limits on the federal credits. The state credit may change in the future if the amount of the federal credit changes.

Health Savings Accounts

Health savings accounts ("HSAs") allow citizens a larger role in their health-care decisions. Citizens who are more engaged in managing their own health care will make better-informed decisions, resulting in healthier outcomes at lower costs.

Health Savings Accounts, coupled with insurance, are often a more affordable option for small businesses that may have trouble paying for more traditional insurance plans. And it makes high deductible plans more affordable for workers who may have chosen not to be insured in the past because they couldn't afford it.

Under *JOBS for Kentucky*, HSAs will now receive the same tax treatment at the state level as they currently have at the federal level.

Health savings accounts allow consumers to save pretax money to use for qualified medical expenses at any point — without paying taxes on the contribution or accumulated earnings upon withdrawal.

In order to qualify for an HSA, individuals need to have a health-insurance policy with a deductible greater than \$1,000; for a family, a deductible of more than \$2,000. High-deductible health plans have much lower premiums than comprehensive insurance.

Health savings account contributions can be put in all investments approved for individual retirement accounts.

When an account holder has a medical expense, the individual withdraws the money to pay for the medical expenses. Allowable medical expenses are similar to those expenses allowable under flexible spending accounts (FSA). Unused money may roll over from year to year, and long-term care insurance premiums are an allowable expense with an HSA, unlike the situation with flexible spending accounts.

There are also benefits to the employer. An employer is not taxed on the amount contributed to the account, and these amounts are also not subject to withholding for income, Federal Insurance Contributions Act (FICA) or Federal Unemployment Tax Act (FUTA) taxes. Therefore, an employer obtains a direct write-off for the amounts paid, not only for the health insurance premiums, but for the HSA as well.

HSAs are one of many elements of Governor Fletcher's broad plan to move Kentucky in a healthier and smarter direction as well as create better access to quality care for our citizens.

They complement the Small Business Health Package (House Bill 278), which also passed in the 2005 session. HB 278 helps provide access to health care for many small business entrepreneurs who have not been able to afford health insurance for their employees. Insurance will be more affordable with the option of purchasing plans that include fewer mandates on coverage.

Exempt Phase II Supplemental Payments

Kentucky has a history of excluding from income tax any special income related to tobacco farming. The 2005 General Assembly provided \$27 million in General Fund moneys from a transfer of Tobacco Settlement Funds from the Agriculture Development Fund and \$87 million in Bond Funds, for a total of \$114 million, for state Phase II Tobacco Settlement Payments, to replace the 2004 Phase II payments that were not made in December of 2004.

JOBS for Kentucky exempts those payments to Kentucky tobacco farmers from Kentucky corporation and individual income taxes.

By excluding these payments from income tax, the Commonwealth reaffirms a strong commitment to Kentucky's agricultural heritage. Excluding this income from taxation provides assistance to the agricultural community and continues to foster efforts to find alternative crops and reduce the dependence of farmers on a dwindling income source.

Military Family Relief Act

JOBS for Kentucky retroactively conforms the Kentucky income tax provisions to the federal act with regard to tax treatment for military income.

The federal provisions are effective on the dates specified in the Act and include:

- Exclusion of gain on sale of a principal residence by a member of the uniformed and foreign services;

- Treatment of death gratuities payable with respect to deceased members of the armed forces: a) increase the death gratuity benefit for members of the armed forces to \$12,000; b) exclusion from gross income of certain death gratuity payments;
- Exclusion for amounts received under the Department of Defense Homeowners Assistance Program;
- Modification of membership requirement for exemption from tax for certain veterans' organizations;
- Treatment of service academy appointments as scholarships for purposes of qualified tuition programs and Coverdell Education Savings Accounts;
- Above-the-line deduction for overnight travel expenses (not exceeding per diem levels) of National Guard and reserve members traveling more than 100 miles from home; and
- Tax relief and assistance for families of astronauts who lose their lives in the line of duty.

Improving Economic Development

Repealing onerous taxes and reducing tax rates

JOBS for Kentucky contains seven major business tax **components that will stimulate investment** in Kentucky and treat competitors similarly, which will make the tax code more equitable.

Several states have unsuccessfully attempted similar reforms, but Kentucky was successful, and our citizens and businesses will be the beneficiaries for generations to follow.

JOBS for Kentucky:

- Eliminates the corporation license tax;
- Eliminates the intangible tax on property;
- Reduces the corporation income tax rates;
- Includes limited liability entities in the corporation income tax;
- Creates an alternative minimum calculation;
- Closes loopholes; and
- Expands the sales tax nexus standard.

Most of the income tax provisions apply to tax years beginning on or after January 1, 2005, unless otherwise specified.

Eliminates the corporation license tax and fixes the ITW situation

Repealing the corporation license tax will help to stimulate Kentucky's economy. According to economic development officials, the license tax has discouraged businesses from locating or expanding in Kentucky.

The elimination of the tax also fixes a constitutional problem. Under the prior statute, corporations organized within Kentucky were allowed a preferable license tax calculation, while out-of-state corporations were not given the same consideration.

An out-of-state corporation, Illinois Tool Works, Inc., (ITW) sued Kentucky, alleging that the deduction was unconstitutional since it favored in-state corporations over those not domiciled within Kentucky. The courts found in 2003 that the differential treatment was unconstitutional and removed the deduction from all corporate license taxpayers. The result was an unintended, significant increase in tax liability for Kentucky corporations.

Although the finding was expected, the remedy was not. All parties expected the court to extend the deduction to all corporate taxpayers. Governor Fletcher temporarily suspended the collection of this portion of the license tax, but the statute required further amendment to achieve a permanent solution. *JOBS for Kentucky* accomplishes this permanent solution through the eventual repeal of the entire tax effective for all tax periods ending on or after December 31, 2005.

Additionally, *JOBS for Kentucky* provides an interim, continuous fix related to the unconstitutional provisions of the old law by allowing the deduction or consolidated return option for both domestic and foreign companies that hold stock or securities in subsidiaries equal to 50 percent or more of their total assets. Bank holding companies were afforded the deduction option by legislation enacted by the 2004 General Assembly (House Bill 290).

This fix means that companies will face no additional tax liability even though the current legislative fix had expired. There will be no gap in the treatment of this issue between the legislative “ITW fix” and the total repeal of the corporation license tax.

The repeal of the corporation license tax is highly stimulative because it creates strong incentives for the formation and development of capital investment within the Commonwealth. Most corporations subject to the license tax will benefit from the enactment of *JOBS of Kentucky*, including holding companies that would have paid more license tax under the *Illinois Tool Works* decision.

Five states bordering Kentucky impose some form of corporate license tax, as shown in Figure 4.

Figure 4
Corporate License Tax
for Contiguous States



* Kentucky – Tax imposed on Corporations, but not Limited Liability Companies.

** Ohio – Greater of net income or net-worth based tax.

Source: Commerce Clearing House, Inc.

Repeals the intangible personal property tax

The general intangible property tax currently applies to a variety of items remaining after the *St. Ledger* court case ended the taxation of stocks and stock-related items (e.g., mutual funds) in 1997. This tax, the proceeds from which are all state revenue, now applies primarily to businesses and business activities, and some individuals. The tax remains on money market accounts, bonds, loans, notes, mortgages receivable, land contracts, trusts, cash, deposits, accounts receivable and other types of intangible personal property. Approximately 61 percent of intangible property tax revenues are derived from the tax on business accounts receivable.

Because it is such a complex law, taxpayers and the Department of Revenue must make careful distinctions between taxable and nontaxable types of intangible property. The complexity of the intangible property tax makes it difficult to understand and contributes to misconceptions in studies of comparative tax burdens. Its complexities result in numerous taxpayers being unaware of their obligations. Because of this, noncompliance is believed to be widespread.

JOBS for Kentucky exempts intangible personal property from state taxes, effective January 1, 2006.

Most states do not tax intangible property, so repeal of the intangible property tax removes a tax that deters businesses from locating in Kentucky.

Reduces corporation income tax rates

Kentucky is open for business. The *JOBS for Kentucky* approach is to lower the rate of taxation and broaden the base, add stability and predictability to the revenue stream, and foster a competitive environment. Multi-state corporations choose among sites in 50 states and internationally for expansion and development. Through the reduction of the corporation income tax rates, the right signal is sent to companies considering investment in Kentucky.

For taxable years beginning on or after January 1, 2005, and prior to January 1, 2007, the corporation income tax brackets are as follows:

- 4 percent of the first \$50,000 of taxable net income;
- 5 percent of the next \$50,000 up to \$100,000;
- 7 percent of all taxable net income over \$100,000.

For taxable years beginning on or after January 1, 2007, the corporation income tax brackets are as follows:

- 4 percent of the first \$50,000 of taxable net income;
- 5 percent of the next \$50,000 up to \$100,000;
- 6 percent of all taxable net income over \$100,000.

The corporation income tax rate restructuring helps stimulate Kentucky's economy. Economic development experts confirm that a top corporation income tax rate of 8.25 percent has discouraged operations from locating or expanding in Kentucky.

Reducing Kentucky's top corporation income tax rate to 6 percent over the next two years puts the Commonwealth in a tie with Virginia for having the lowest top corporation income tax rate in comparison to its border states.

Figure 5 reflects the reduced corporation income tax rates compared to the rates in place prior to *JOBS for Kentucky*.

Figure 6 outlines the income tax rates of states surrounding Kentucky. Kentucky's top rate was higher than all but three of its border states.

Figure 5

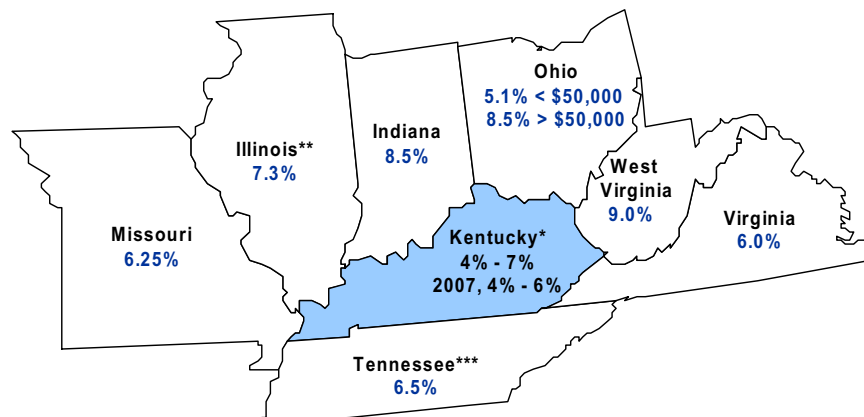
Corporation Income Tax Rates are Reduced

Taxable Income	Tax Rate	
	Old Law	New Law
First \$25,000	4.00%	4.00%
Next \$25,000	5.00%	4.00%
Next \$50,000	6.00%	5.00%
Next \$150,000	7.00%	7.00% / 6.00%*
Over \$250,000	8.25%	7.00% / 6.00%*

*7% effective for 2005 and 2006; 6% thereafter

Figure 6

Corporate Tax Rates for Surrounding States



* Kentucky – Top rate reduces to 6% in 2007

** Illinois - Includes an additional 2.5% of personal property replacement tax imposed for corporations other than S-corporation, 1.5% for S-corporations, partnerships and trust.

*** Tennessee - Corporations are also subject to the tax on dividends and interest.

Source: Commerce Clearing House, Inc.

Broadening the tax base

Includes limited liability entities in the corporation income tax

Businesses currently pay approximately 43 percent³ of all taxes paid in Kentucky. Furthermore, they act as agents in collecting the bulk of personal income and sales taxes. But the distribution of the burden among the various entities doing business in this state has depended too much on the ability of a business to alter its organizational form and too little on its use of Kentucky public services and the Kentucky marketplace to earn income.

Under previous law, corporations could form layered structures involving different organizational forms to legally minimize their corporation income tax liability in Kentucky. Such state tax planning increased in relative importance since 1986, when federal corporate income tax rates dropped significantly. The reduction in the federal tax rates created two incentives to minimize state tax burdens: it lowered the value of state taxes paid as a federal deduction, and state taxes became a higher percentage of total taxes paid.

The explosion in the formation of limited liability companies (LLCs) – from 415 LLCs per year in 1994 to almost 12,000 in 2003 – attests to the advantages promoted by the tax laws prior to *JOBS for Kentucky*. Although significant amounts of income tax on these forms of business have been collected through the individual income tax, disparities existed in the definition of the base, the method of income apportionment and the rates. *JOBS for Kentucky* ensures the total tax burden on business will yield a stable stream of revenues to fund the vital operations of state government, but distributes it more evenly and responsibly.

Expanding the corporation income tax to be an entity-level tax on all businesses with limited liability protection results in a broader tax base than the former corporation income tax. Rate reductions and the repeal of the license tax would not have been possible in the old environment with a narrower base.

In addition, individual partners, members and shareholders will continue to offset their share of a loss distributed by a partnership, LLC or S-corporation against income from other sources.

³*Business Taxation in Kentucky*, David E. Wildasin, Martin School of Public Policy, University of Kentucky, December 1, 2003.

Creates an alternative minimum calculation

Under prior law, some multi-state business entities were able to eliminate or reduce their tax burden by shifting profits out of state. When fewer companies pay taxes, other tax rates must be higher in order to maintain revenues.

The alternative minimum calculation ensures that every entity with limited liability doing business in Kentucky will pay some tax. The overall tax burden is redistributed across the entire business population — eliminating the need to continuously increase corporate tax rates.

In order to mitigate the impact of the alternative minimum calculation on high-volume/low-margin businesses, a second method of computing the calculation was enacted allowing the alternative minimum calculation to be computed on Kentucky gross profits rather than Kentucky apportioned gross receipts.

The lower of these two calculations is then compared to the net income tax liability and the minimum tax of \$175. It is the greatest of these three amounts that is then due to the Commonwealth.

Once again, lowering tax rates would not have been possible without collective, courageous action. The repeal of the corporation license tax and the reduction of the top marginal rate could not have occurred without the broadening of the tax base and the closing of loopholes.

Moreover, the addition of the alternative minimum calculation further broadens the base and creates stability. This collection of important reforms is the backbone of *JOBS for Kentucky*.

Closes loopholes in the tax code

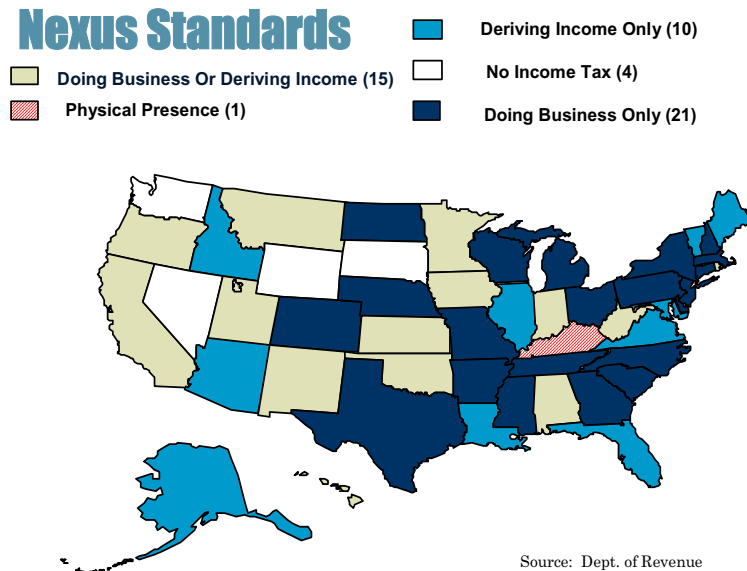
JOBS for Kentucky closes loopholes in business taxation — resulting in significant base broadening under the corporation income tax. Specifically, loopholes in the current tax code are addressed by:

- **Requiring nexus consolidated filing for corporation income tax:** Nexus refers to the legal tie or link that gives a government the ability to levy a tax on an entity or person. Prior to enactment, groups of corporations could elect to file a

consolidated return including all members eligible to file a federal consolidated return. Requiring a nexus consolidated return eliminates the group’s choice to reduce its net income when feasible.

- **Disallowing certain deductions to related parties:** Business entities conduct millions of related party transactions that are reasonable. *JOBS for Kentucky* does not impact those transactions. *JOBS for Kentucky* now codifies the provisions that must be met for a disclosed deduction to be allowable and is comparable to laws in other states.
- **Disallowing net operating loss carrybacks:** Receiving refunds today of money paid into the State Treasury two years ago creates an unreliable revenue stream. The carry forward of net operating losses remains permissible for up to twenty years after the loss is incurred.
- **Changing the income tax nexus standard:** Prior to enactment, the income tax nexus standard required a “physical presence” in Kentucky. Changing this standard to a “doing business” standard broadens the base and removes an inequity that placed companies that have made significant commitments in this state at a disadvantage. Figure 7 reflects that Kentucky was the only state in the nation that required a physical presence to establish nexus for taxation.
- **Requiring three-factor apportionment for all limited liability entities:** Before *JOBS for Kentucky*, certain limited liability entities apportioned income to Kentucky using a single factor based upon sales. Corporations use a three-factor formula based upon double-weighted sales, property and payroll. Requiring a three-factor formula for all business entities with limited liability levels the playing field and treats similar businesses equally.

Figure 7



Expands the sales tax nexus standard

The 1992 Supreme Court decision in *Quill Corp. v. North Dakota* confirmed that states could not force remote sellers to collect sales and use tax unless the sellers have a physical presence in the state.

To take advantage of this loophole, some traditional retailers (“bricks and mortar” businesses) with a national or regional presence have begun to break out their Internet sales capabilities into separate subsidiaries.

For example, a company may have stores in every state, but it does not collect tax on sales it makes over the Internet because it claims that the actual seller is its subsidiary, a “dot-com” company.

Products purchased online usually can be returned for refund or exchange at the local store. To the consumer, there is no distinction between doing business with the local store or with its dot-com affiliate. This form of tax avoidance creates a disadvantage for local retailers with only a “bricks and mortar” presence.

Recent reports indicate that 63 percent of Kentucky adults now have Internet access, with online sales to U.S. consumers reaching \$54.9 billion in 2003.

Even though purchases from remote sellers is increasing, voluntary use tax reporting on Kentucky individual income tax returns is flat and even declining slightly each year.

JOBS for Kentucky expands the sales and use tax nexus standard to include remote sellers who use their in-state store location, affiliate or other representative to exploit this tax advantage. Although there is a small fiscal impact related to this change in the nexus standard initially, it is expected to be a growing area of concern if not addressed.

Main street merchants now will be able to compete on a more level playing field. In addition, some tax base erosion is eliminated by the change to current nexus standards, and consumers have the convenience of the tax being collected at the point of sale rather than having to report their use tax liability on their income tax returns.

Conservative estimates indicate that General Fund losses from Internet purchases could have approached \$200 million in 2004⁴. However, in order to realize the full revenue impact, federal legislation requiring remote sellers to collect the tax for states will be needed in addition to this change to Kentucky's sales and use tax nexus standard.

The sales tax nexus expansion takes effect on August 1, 2005.

For additional information about the modernization of business taxes, see Appendix B entitled, ***Expanded Corporation Income Tax, the AMC, and Other Details of the Business Tax Changes.***

⁴Donald Bruce and William F. Fox, "State and Local Tax Revenue Losses from E-Commerce: Estimates of July, 2004."

Kentucky Enterprise Initiative Act

Outside the current Enterprise Zones, Kentucky offered no general sales tax exemption to businesses for building materials.

As the Enterprise Zones continue to expire over the next few years, this method of inducing new business formation and existing business expansion will be lost. Zones already have expired in Louisville, Hickman, Covington and Ashland. Zones in Owensboro and Lexington will expire at the end of this year.

Because the number of zones was limited to 10, businesses, legislators and local officials in other areas of the state have shown interest in spreading the benefits of the program.

In addition, Kentucky offered no sales and use tax exemption for research and development to encourage investment in New Economy industries.

JOBS for Kentucky creates a new tax incentive program, the Kentucky Enterprise Initiative Act (KEIA) to replace and improve upon the expiring Enterprise Zone program. The program will:

- Extend to eligible companies statewide a refund of sales and use tax on construction materials and building fixtures;
- Limit eligibility to certain industries, including tourist attractions, service and technology, and manufacturing, but allow regional or headquarters facilities in any industry to qualify;
- Give preference to companies locating in existing Enterprise Zones that existed as of December 31, 2003;
- Allow a sales and use tax refund for research and development equipment purchases; and
- Cap fiscal year commitments to \$20 million for construction materials and building fixtures and \$5 million for R&D equipment.

To preserve the original intent of the Enterprise Zone program, KEIA gives priority for the next three years to companies located within an Enterprise Zone as of December 31, 2003, which under this program will be known as Preference Zones.

In keeping with the intent of the original Enterprise Zone program, the minimum investment is set low enough (\$100,000 for

companies within an Enterprise Zone as of December 31, 2003; \$500,000 elsewhere) to allow small businesses to qualify for these inducements.

KEIA allows elements of the Enterprise Zone program that were problematic to expire — notably the motor vehicle usage tax exemption and the building material exemptions for non-certified companies and residents.

To improve accountability, KEIA requires that projects and expenses be approved by the Kentucky Economic Development Finance Authority (KEDFA) and that the Department of Revenue refund sales taxes paid on eligible expenses, rather than providing a blanket exemption. These changes will significantly improve the Commonwealth's ability to monitor and hold accountable the companies receiving tax incentives.

KEIA will give economic development officials across the state an additional tool to recruit industries with significant capacity to grow, employ Kentucky residents and compete in the New Economy.

Sales tax exemptions for research and development equipment are becoming more popular. Fifteen states have adopted laws exempting research and development equipment from sales taxation. Seven other states offer some sort of sales tax relief for research and development equipment. Of the neighboring states, only Ohio and Virginia currently exempt R&D equipment from the sales tax.

Equine Breeder Incentive Funds

While the Fletcher Administration realizes the importance of recruiting new industry to Kentucky, it also understands the need to promote policies that keep existing industries viable as well.

Kentucky's equine industry has a \$4 billion impact in Kentucky and directly or indirectly generates 80,000 jobs. It also is a vital component of the Commonwealth's \$8.8 billion tourism industry.

In recent years, Kentucky had no incentives for horse breeders. Other states then lured away mares that previously had been sent to Kentucky. Two of the last three Kentucky Derby winners were foaled in other states: Pennsylvania and New York, which have large incentive programs.

New York offered \$6.5 million in breeding awards last year and about \$40 million in total incentives annually. Pennsylvania is expected to increase its state incentives from about \$9 million to at least \$25 million. Similarly, Louisiana has improved its position in the thoroughbred industry by increasing incentives.

Because they have a much smaller number of foals, the incentive per horse is larger. There were nearly 9,000 Kentucky-bred foals registered in 2003. In comparison, New York averages less than 2,000 foals per year, while the number in Pennsylvania is less than 1,000.

This disadvantage is especially burdensome for small farms, whose main business is boarding out-of-state mares.

JOBS for Kentucky establishes a fund for horse breeders using the sales and use tax collected on fees paid for breeding a stallion to a mare in this state. A Kentucky Thoroughbred Breeders Incentive Fund, a Kentucky Standardbred Breeders Incentive Fund and a Kentucky Horse Breeders Incentive Fund are established to provide incentives and rewards to horse breeders in Kentucky.

By January 1, 2006, the Kentucky Horse Racing Authority will establish administrative regulations outlining the conditions and criteria for the distribution of money from the fund. The three incentive funds will begin to provide breeder rewards from the accumulated sales and use tax receipts at that time.

Eighty percent of the sales and use taxes on stud fees collected will be deposited in the Thoroughbred Breeders Incentive Fund; 13 percent of the sales and use taxes on stud fees collected will be deposited in the Standardbred Breeders Incentive Fund; and 7 percent of sales and use taxes on stud fees collected will be deposited in the Horse Breeders Incentive Fund.

As a result, Kentucky will regain competitiveness with other states.

Lodging Tax Initiative

JOBS for Kentucky imposes a 1 percent lodging tax on all hotel and motel room charges and dedicates the funds to marketing the state.

Research conducted by the Department of Travel in the Kentucky Commerce Cabinet concluded that every dollar spent on advertising promotion has resulted in a \$30 return on investment.

The additional funding for tourism promotion will allow the state to more readily compete for potential travelers. Kentucky has historically ranked below the national average in both overall budget of the tourism office and advertising dollars spent to promote tourism. In 2003, Kentucky's tourism budget ranked 28th in the nation.

When comparing only the 12 southern states, Kentucky ranked second to last in advertising expenditures.

Like most states, Kentucky authorizes local governments to levy transient room taxes with significant restrictions. Kentucky cities impose a variety of room taxes, as permitted by law. However, Kentucky has never before had a statewide tax to promote this important industry.

It is estimated that when tourists visit Kentucky, lodging accounts for 25 to 40 percent of their expenditures. Given Kentucky's geographic position and important interstate highway system, it is estimated that 80 percent of a statewide lodging tax will be borne by non-residents.

The proceeds from the tax will be used to:

- Boost Kentucky's presence in the meetings, conventions and group travel market.
- Dramatically increase money available to the nine Kentucky tourism regions in the form of matching funds.
- Conduct expanded research that assists the state in determining likely visitor profiles, effectiveness of advertising and marketing efforts, and the potential for new product development, such as Kentucky golfing trails.
- Increase consumer awareness of Kentucky as a travel destination through integrated advertising and marketing programs, with a special emphasis on the Internet. The Internet is the largest source of travel information now in use and continues to grow. In recent focus group research, many respondents cited lack of knowledge about Kentucky as the main reason they have not visited.
- Take advantage of tourism trends in niche markets through special promotion and development programs.

Tourist attractions and related businesses will benefit as a result of increased and more organized promotion.

Environmental Stewardship Credits

JOBS for Kentucky provides an income tax credit for any entity that undertakes an environmental stewardship project with a minimum investment of at least \$5 million. The credits will cover 100 percent of eligible skills upgrade training costs and up to 25 percent of eligible equipment costs.

New investment in equipment used to manufacture an environmental stewardship product and in occupational training programs will be eligible.

An environmental stewardship product is defined to mean a new manufactured product or substantially improved existing manufactured product that has a lesser or reduced adverse effect on human health and the environment, or provides for improvement to human health and the environment when compared with existing products or competing products that serve the same purpose. The Environmental and Public Protection Cabinet may be called upon to make recommendations as to whether proposed projects fit the definition of environmental stewardship product.

In addition, there are wage and benefit requirements. Within six months after the activation date, the approved company shall compensate a minimum of 90 percent of its full-time employees with base hourly wages equal to either 75 percent of the average hourly wage for Kentucky or 75 percent of the average hourly wage for the county in which the project is to be undertaken.

The minimum base hourly wage shall be 150 percent of the federal minimum wage. In addition, the eligible company must provide employee benefits equal to at least 15 percent of the applicable base hourly wage.

The maximum amount of credit claimed for any single fiscal year may not exceed 25 percent of the total authorized inducement.

Companies must make their investment in the project within three years of final approval by the Kentucky Economic Development Finance Authority and may use the credits over a period of 10 years.

As a result, Kentucky will attract and retain businesses that are a vital part of the New Economy as well as ones that participate in making environmentally friendly products. In addition, Kentucky workers will be trained in new skills that will make them more valuable employees and improve their marketability.

Expanded Recycling Credits

Expanded recycling credits are made available in *JOBS for Kentucky* for major recyclers who make a significant investment in plant and equipment as well as meet certain employment standards.

A major recycling project is defined to be a project where the taxpayer invests more than \$10 million in recycling or composting equipment to be used solely in Kentucky; has more than 750 full-time employees with average hourly wages of more than 300 percent of the federal minimum wage; and has plant and equipment with a total cost of more than \$500 million.

Credits for major recycling projects are allowed for up to 50 percent of the cost of new and expanded recycling equipment, and are limited annually per qualifying taxpayer to the lesser of \$2.5 million or 50 percent of the taxpayer's total tax liability in excess of its baseline tax liability. The expanded credit is available for tax years beginning after December 31, 2004.

Enhancing Communities and the Environment

Historic Preservation Credits

More than 200 of the 385 districts in Kentucky that are included in the National Register of Historic Places have 20 percent or more of their households living below the poverty line. Historic preservation credits restore some of the Kentucky heritage and tradition to areas of the Commonwealth that have suffered years of neglect.

JOBS for Kentucky establishes a credit for qualified residential or commercial restoration expenditures to structures listed individually or located in a historic district listed in the National Register of Historic Places.

The residential credit is equal to 30 percent of the approved costs, not to exceed \$60,000 per project. The commercial credit is 20 percent with no cap. The residential credit is higher because there is no accompanying national credit, which exists for commercial projects.

Individuals or businesses can apply the credits against their income tax liability. If insufficient liability exists, the credit can be carried forward for seven years or transferred to a banking institution to be used against the bank franchise tax. Transferability to banks helps individuals or businesses obtain financing for projects by pledging their future credits as collateral.

This legislation is very similar to the restoration credits in Missouri and Maryland, where credits have been extremely popular and effective.

Communities and tourism will benefit from these improvements. According to the Kentucky Heritage Council, for every \$1 million invested in rehabilitation of property, state and local governments see an increase of \$184,000 in new revenue. By restoring these valuable treasures, these neighborhoods and historical regions will once again become areas of pride and commerce.

The total amount of credits issued will be capped at \$3 million per year. The Kentucky Heritage Council will be responsible for approving projects and certifying the qualified expenditures.

Brownfield Remediation Credits

Brownfields, which are properties that lie abandoned due to real or perceived contamination, are a problem for both large and small communities throughout the Commonwealth.

They create health and environmental problems, reduce property values and tax revenues, and add to urban blight. By not returning brownfield locations to productive use, Kentucky's prized "greenfields" are being more rapidly developed.

Redevelopment is, in essence, land recycling. One of the chief obstacles to redeveloping brownfield properties is a lack of financial incentives. Kentucky has an abundance of open space, and it is usually cheaper and quicker to build on a greenfield than to cleanup and renovate a brownfield. According to the U.S. Department of Agriculture, Kentucky is losing farm land at the rate of 130 acres per day.

States with successful programs typically have a variety of financial incentives to help even the playing field between brownfields and greenfields. However, Kentucky did not have any financial incentives directed specifically at brownfields.

JOBS for Kentucky provides property tax relief and income tax credits for certain remediation projects in Kentucky.⁵ The Environmental and Public Protection Cabinet estimates that as many as 25 projects annually could receive these incentives.

The Voluntary Environmental Remediation Program, established in 2001, was intended to establish an efficient and predictable process to promote voluntary cleanup and redevelopment of properties suspected of environmental contamination. The goal is to protect human health, safety and the environment while stimulating economic development and job creation through the construction of new residential, commercial and industrial facilities.

⁵To qualify, a project must be remediated and receive a covenant not to sue under the Voluntary Remediation Act.

JOBS for Kentucky creates two forms of inducements for the remediation of brownfield sites where a covenant not to sue has been issued by the Environmental and Public Protection Cabinet:

- Reduced real property tax rate of \$.015 per \$100 of value for approved properties for 3 years; and
- A tax credit against individual or corporation income tax of up to \$150,000 per entity for taxpayer expenditures made in order to meet the requirements of an agreed order between the taxpayer and the cabinet. The agreed order must establish the mutual responsibilities of the parties with respect to the remediation project. The income tax credit is limited in any year to 25 percent of the total credit approved and may be carried forward for 10 years.

By taking previously undesirable land and turning it into sites that produce jobs, income and tax revenue, Kentucky's economy and environment will benefit.

Brownfield tax incentives encourage action that will not otherwise be taken. They will increase the number of sites being cleaned up and returned to productive use under state regulatory oversight. Incentives will spur environmental cleanup and decrease risks to human health.

Financial incentives also will encourage private individuals to clean up properties that otherwise may have required Superfund dollars.

Biodiesel Credits

Biodiesel is a renewable fuel derived from a wide range of vegetable oils and animal fats. It may be used as an additive to diesel fuel in various blends ranging from 2 to 100 percent. Nontoxic and biodegradable biodiesel is the only alternative fuel to have fully completed the health effects testing requirements of the Clean Air Act.

JOBS for Kentucky allows Kentucky biodiesel producers and blenders of biodiesel a nonrefundable tax credit against income taxes. The credit rate is equal to one dollar (\$1) per biodiesel and blended biodiesel gallon unless the total amount of approved credit for all biodiesel producers and blenders exceeds the annual biodiesel tax credit cap.

The credit is nonrefundable, nontransferable and cannot be carried forward. The credit is available for tax years beginning on or after January 1, 2005.

The total available incentive per year for the biodiesel program is \$1.5 million. In the event that the total number of gallons produced or blended exceeds the cap, the credit will be distributed to qualifying producers and blenders based on an apportionment formula reflecting the credit received by each producer or blender relative to the total credits available.

The use of biodiesel fuel in a conventional diesel engine results in substantial reduction of unburned hydrocarbons, carbon monoxide and particulate matter compared to emissions from standard diesel fuel. In addition, the exhaust emissions of sulfur oxides and sulfates (major components of acid rain) from biodiesel fuel are essentially eliminated compared to diesel.

Clean Coal Credits

Although there has been robust growth in the Kentucky coal industry recently, the production of Kentucky coal has been slowly declining in the last 15 years. In 2003, production was approximately 115 million tons, a decrease of 65 million tons from 1990.

For every million tons of coal produced in Kentucky, 130 coal miners are employed, and \$1.25 million in severance taxes are collected.

JOBS for Kentucky provides a tax credit for any entity that builds a certified clean-coal electricity generating facility costing \$150 million or more and purchases coal for which coal severance taxes are paid.

The credit also is extended to the parent of a wholly-owned subsidiary and will be effective for electric generation facilities beginning commercial operations after January 1, 2005.

It is a nonrefundable, nontransferable credit against corporation income, individual income and public service property taxes, in consecutive order.

Investment in clean-coal technology will reduce emissions in Kentucky and make Kentucky coal more competitive by

significantly reducing regulated emissions. As the industry invests in new clean-coal generation, the credit will enhance Kentucky coal's competitiveness and promote coal production and jobs in Kentucky.

This credit, along with the tax credits for biodiesel and environmental stewardship projects, are part of the Governor's comprehensive energy plan, which seeks to preserve our low-cost energy, responsibly develop Kentucky's energy resources and preserve a commitment to environmental quality.

This credit is equal to \$2 per ton of eligible coal that is purchased for combustion in a Kentucky-certified "clean-coal facility" in the calendar year. In the case of a general partnership, the amount of the credit allowed is apportioned among the partners at the same ratio as the partners' share of distributive income for the tax year. Any unused credit in a taxable year cannot be carried forward to a return of another period. It will not be allowed in connection or addition to the coal incentive tax credit in KRS 141.0405.

Before any credit can be claimed on any tax return, the Environmental and Public Protection Cabinet must certify the facility as one that will reduce emissions of pollutants released during generation of electricity from Kentucky coal through the utilization of clean-coal equipment and technologies.

Local tax study task force

Governor Fletcher and the General Assembly realize that the local tax structure needs modernization as well. However, it has not been studied as extensively as have state taxes.

JOBS for Kentucky creates a task force of the Legislative Research Commission with representation from the executive branch, the legislative branch, local governments and school districts to study the methods of taxation utilized by local governments.

The group is directed to review and evaluate the current structure of local taxation and prepare a report and recommendations for submission to the General Assembly by November 1, 2005.

The task force will review the current structure of local taxation, including:

- The constitutional requirements regarding local taxation;
- Current taxes imposed by local governments including the rates and tax base;
- The local tax burden in various Kentucky cities and counties;
- Revenues generated by type of tax, including all permissible local taxes; and
- Existing economic development incentives available to local governments and how effectively those incentives are used by local governments.

After reviewing the current structure of local taxation, the task force shall prepare a report and recommendations that address at least the following areas:

- The identification of any constitutional impediments to the development of a modern local tax system, and proposed constitutional amendments to address any identified issues related to existing constitutional language;
- An analysis of the existing tax structure, including identification of the taxes that are effective and those that are ineffective;
- The identification and recommendation of alternative methods for generating a comparable amount of local revenue, including the imposition of a local sales tax;
- An analysis of the existing economic development incentive programs available to local governments; and
- A recommendation of alternative methods for promoting capital investment and job creation on the local level.

Other Initiatives

A modern, fair and constitutional telecom-munications tax

Before the enactment of *JOBS for Kentucky*, the taxation of telecommunications services was based on a tax structure that dated back not just to the rotary phone, but to the time of Alexander Graham Bell.

The property tax on cable companies had even been declared unconstitutional. This problem was highlighted by a court decision⁶ that declared the franchise value of both cable and direct broadcast satellite (DBS) should be taxed similarly. Under Kentucky's tax structure, DBS was not subject to any taxation. As a result, existing taxes were an unreliable source of revenue for funding important local and state programs.

The rapid evolution of technology made Kentucky's telecommunication taxes ill-equipped to handle today's technology: cable television, Internet, wireless or cellular telephones, broadband and satellite services.

The emergence of new communications technologies and the convergence of existing technologies highlighted the inadequacy of the tax system. The time had come to modernize a 19th century tax structure for the 21st century reality.

JOBS for Kentucky applies a single excise tax rate of 3 percent on cable and direct broadcast satellite. In addition, an internal gross receipts tax is levied on cable and DBS providers at a rate of 2.4 percent of gross receipts, and on telephone service providers at a rate of 1.3 percent of gross receipts.

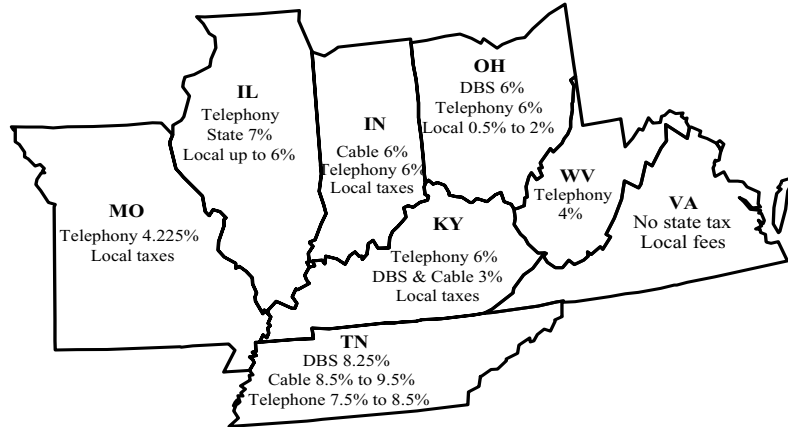
These rates were established to replace state and local revenues from the franchise value tax and the local franchise fees. The telephone rate includes the removal of switch access from the sales and use tax base. This base reduction addresses a long-standing equity issue within the industry. Figure 8 reflects that the taxation of these services is competitive as compared to neighboring states.

In addition, *JOBS for Kentucky* equalizes the tax treatment of cable and DBS services at the local level. Kentucky school districts that impose the utilities gross receipts tax on cable services must either also impose the same rate of taxation on DBS services, or discontinue levying of this tax on cable services.

⁶*Insight Kentucky Partners II, L.P. v. Revenue Cabinet, KY TAX REPORTER CCH) ¶202-722 (Franklin Cir. Ct., Division II, Civil Action No. 01-CI-01528, February 5, 2004 opinion and order)*

Figure 8

Communications Services Taxes In Surrounding States



Sources: Telephone conversation with tax administrators, February 2004;
KY updated for passage of HB 272.

The new tax structure provides a more uniform, fair and modern tax structure by:

- Eliminating local city and county franchise fees imposed on in-state telephone and cable services;
- Eliminating state and local property tax imposed on the franchise value of telephone and cable companies;
- Eliminating tax on switch access charges;
- Guaranteeing local governments a fixed amount to replace the Public Service Commission ("PSC") property tax and franchise fees, and provide a percentage share in any growth to the communications tax base;
- Taxing all end-users of cable and DBS services on the same basis; and
- Providing a solution for the erosion of the PSC property tax from both legal challenges and the decline in assessed value; and increasing compliance because the tax will be collected by a single taxing entity, the Kentucky Department of Revenue. This will vastly improve the efficiency of collection, providing local governments and school districts with a steady, uncontested flow of revenue.

Businesses, specifically in the area of cable and telephony that pay multiple taxes to numerous jurisdictions, will now pay the tax due directly to the state, instead of more than 1,000 taxing authorities.

The new excise tax on cable and DBS is an end-user tax and does not put Kentucky-based communications companies at a disadvantage.

The effective date for the new taxes is January 1, 2006. Receipts from the new taxes will be distributed to both the state and all local jurisdictions that levy a PSC property tax and franchise fee.

Local government distribution:

The excise tax and the internal gross receipts tax will be collected at the state level by the Department of Revenue. The tax receipts⁷ will be distributed first to local governments at a “hold-harmless” amount of \$36.4 million annually. This is the estimated amount of local government receipts from both franchise fee and the assessed value of the PSC property tax.

The rest of the excise tax money, after deducting DBS receipts estimated at \$15.2 million, will be divided between the state and local governments based upon the historical proportional share of taxes on this industry.

The local government portion is 15.6 percent, and the state share is 84.4 percent⁸ of the total. If the 15.6 percent allocation is less than the local hold harmless amount, local governments still will receive the base amount of \$36.4 million.

Local jurisdictions have a stake in the communications excise tax revenue. These jurisdictions include city and county governments, school districts, and a range of special districts like libraries, fire districts and ambulance services. The hold-harmless distribution to each of these taxing units will be determined by the amount of money they have collected in the past from these taxes.

Each local jurisdiction’s percentage of tax collections reported to the Department of Revenue will form the basis of the monthly payment from the local hold-harmless fund. In addition, any money that is in excess of the hold-harmless fund will be allocated to the taxing districts in proportion to their tax effort.

⁷A small deduction will be made to recompense communications service providers for collecting the tax and the Department of Revenue for processing and disbursement of the receipts. The base for calculation is fiscal year 2005.

⁸The 15.6 percent is local government share under current law of the total collections from telecommunications taxes.

Increasing tobacco taxes

JOBS for Kentucky places a 26-cent surtax on cigarettes, and an additional 1-cent tax per pack is dedicated to cancer research, bringing total excise taxes on cigarettes to 30 cents per pack.

Beginning June 1, 2005, a 26-cent wholesale surtax will be added to each package of 20 cigarettes. An additional 1-cent per pack cigarette surtax is provided for in HB267, the budget bill, which will be deposited in a special fund to be divided equally and matched by the University of Kentucky and the University of Louisville, to be used for cancer research. These surtaxes will be in addition to the existing 3-cent excise tax.

Kentucky has the highest incidence of adult smoking in the country. Smoking has partially contributed to large increases in the cost of health care in Kentucky, both in private insurance and the costs associated with Medicaid. (See Figures 9 and 10.)

Ultimately, the tax is voluntary and entirely avoidable for individuals who choose not to consume cigarettes. Studies also have shown that the price increases associated with a higher tax on cigarettes may lower the incidence of youth smoking, a universally desirable outcome.

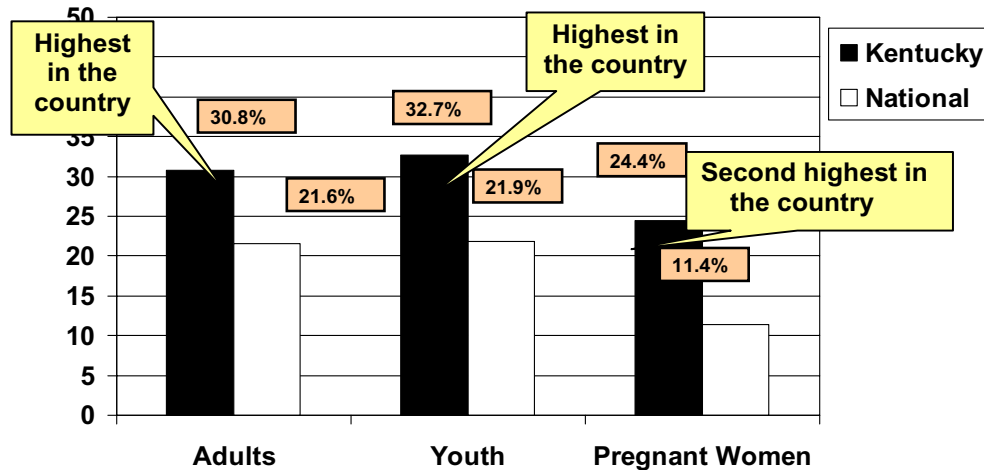
According to the Campaign for Tobacco-Free Kids, for every 10 percent increase in the price of cigarettes, there is a 7 percent decrease in youth smoking. Another formula provided by that organization estimates that Kentucky's cigarette tax increase will prevent 19,400 youths from beginning to smoke.

Figure 11 outlines several disturbing statistics related to smoking in Kentucky and the impact it has on the Commonwealth.

Before the passage of *JOBS for Kentucky*, the Commonwealth's excise tax rate on cigarettes was the lowest in the country. With the national average at 84 cents and the average of the surrounding states at more than 43 cents per pack, Kentucky's tax rate was too far out of line. Figure 12 reflects that Kentucky had the lowest cigarette tax rate in the nation while still providing the most demanding public welfare disbursement derived from tobacco. Moreover, several neighboring states have increased excise taxes on cigarettes in the last year. Figure 13 reflects that Kentucky will still be in a competitive position for the sale of cigarettes after the increase in taxes on those products.

Figure 9

Smoking in Kentucky is highest in the nation



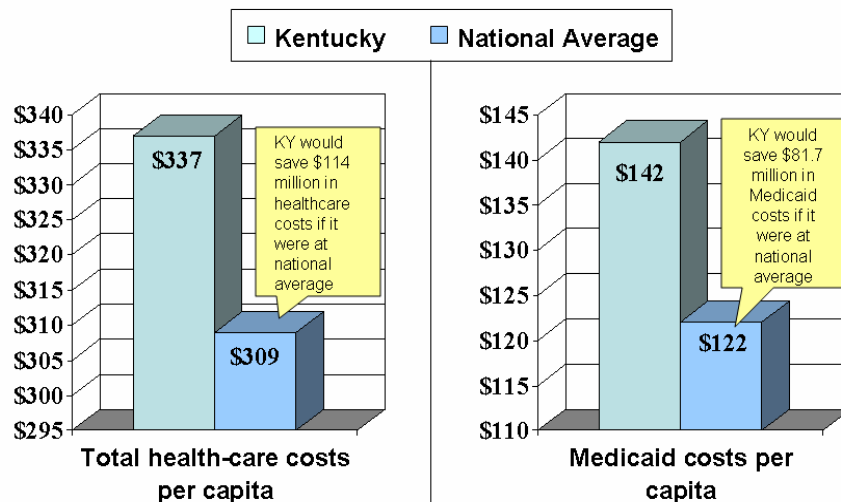
Adult data: KY rate is from 2003 BRFSS; National rate is from 2003 NHIS (est.)

Youth data: Both rates are from the 2003 YRBS

Pregnant smokers data: Both rates are from the 2002 National Vital Statistics Report

Figure 10

Kentucky has higher health-care costs per capita from tobacco than most states



Data are from CDC, 2004 State Highlights. Based on 18+ population

Figure 11

The Toll of Tobacco in Kentucky

Tobacco Use in Kentucky

High school students who smoke	32.7% (73,400)
Male high school students who use smokeless or spit tobacco	23.5% (females use much lower)
Kids (under 18) who become new daily smokers each year	12,700
Kids exposed to secondhand smoke at home	363,000
Packs of cigarettes bought or smoked by kids each year	18.4 million
Adults in Kentucky who smoke	30.8% (962,000)

Nationwide, youth smoking has declined since 1997, but remains at high levels. The 2003 Youth Risk Behavior Surveillance (YRBS) found that 21.9% of U.S. high school kids smoke and 11.0% of high school males use spit tobacco. U.S. adult smoking has decreased gradually since the 1980s, and 22.5% of U.S. adults (about 45 million) currently smoke.

Deaths in Kentucky From Smoking

Adults who die each year from their own smoking	7,700
Kids now under 18 and alive in Kentucky who will ultimately die prematurely from smoking	109,000
Adults, children, & babies who die each year from others' smoking (secondhand smoke & pregnancy smoking)	760 to 1,360

Smoking kills more people than alcohol, AIDS, car crashes, illegal drugs, murders and suicides combined -- and thousands more die from other tobacco-related causes -- such as fires caused by smoking (more than 1,000 deaths/year nationwide) and smokeless tobacco use. No good estimates are currently available, however, for the number of Kentucky citizens who die from these other tobacco-related causes, or for the much larger numbers who suffer from tobacco-related health problems each year without actually dying.

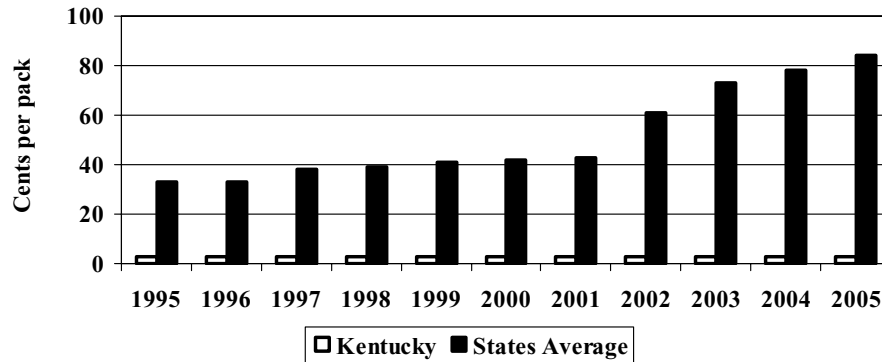
Smoking-Caused Monetary Costs in Kentucky

Annual health-care costs in Kentucky directly caused by smoking	\$1.17 billion
- Portion covered by the state Medicaid program	\$380 million
Residents' state & federal tax burden from smoking-caused government expenditures	\$494 per household
Smoking-caused productivity losses in Kentucky	\$1.84 billion

Amounts do not include health costs caused by exposure to secondhand smoke, smoking-caused fires, spit tobacco use, or cigar and pipe smoking. Other non-health costs from tobacco use include residential and commercial property losses from smoking-caused fires (more than \$500 million per year nationwide); extra cleaning and maintenance costs made necessary by tobacco smoke and litter (about \$4+ billion nationwide for commercial establishments alone); and additional productivity losses from smoking-caused work absences, smoking breaks, and on-the-job performance declines and early termination of employment caused by smoking-caused disability or illness (dollar amount listed above is just from productive work lives shortened by smoking-caused death).

Figure 12

Kentucky has had the Lowest Cigarette Tax Rate in the U.S.



Like most consumption taxes, the burden of this tax falls primarily on those who choose to buy the product. Smoking saps the vitality of users and the resources of the medical community.

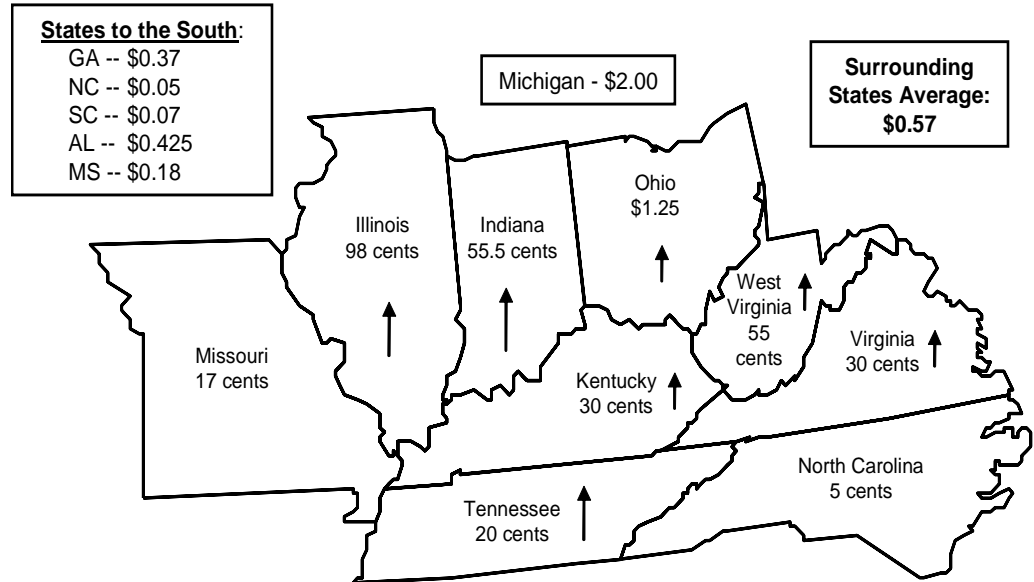
Because of the increased cost to all Kentuckians, it is fair and appropriate to require that a greater portion of this burden be borne by those who freely choose to use these products. It is likely that some will choose to stop using tobacco products as the result of this added burden and that will be good in the long run for them personally and for Kentucky's health as well.

In addition, the commitment of Governor Fletcher to the farming community has not wavered. Rather, the moderate changes in the taxation of tobacco products underscore an understanding of the importance of the farming community in the Commonwealth, tempered with an understanding that marginal user fees on tobacco products are reasonable, appropriate and justifiable.

All of the proposed changes are minor compared to the growing trend of taxation of tobacco across the United States, and none of the changes would produce a noticeable impact on tobacco growers or cigarette manufacturers since the products are sold nationwide and even internationally.

Figure 13

Comparison of Cigarette Excise Tax Rates Updated June, 2005



National Average -- \$0.898 per pack

Other Tobacco Products

Kentucky currently imposes the general sales tax on other tobacco products ("OTP") including but not limited to smoking tobacco, cigars, little cigars, chewing tobacco and snuff, but does not levy an excise tax. *JOBS for Kentucky* imposes the first-ever excise tax on other tobacco products in the state as follows:

- 7.5 percent of gross receipts on OTP other than snuff; and
- \$0.095 per unit of snuff.

The scientific community is in agreement that increasing taxes on tobacco products should have a deterrent effect on their use. It also acknowledges that some in the public health community recognize that tobacco harm reduction should be a complementary strategy to any public health policy towards tobacco products. Taxing tobacco products according to relative risks is a rational tax policy and may well serve the public health goal of reducing smoking-related deaths and lowering health-care costs associated with tobacco-related disease.

**An
increased
wholesale
alcohol
tax**

Kentucky taxes alcoholic beverages at the wholesale level both on a per unit basis as well as on the wholesale price. The per unit taxes rise only as consumption rises, and these revenues have been fairly flat over the last decade.

Kentucky had not changed its alcoholic beverage taxation in 23 years. Meanwhile, more than 30 states proposed changes to their alcohol taxes in recent years.

In order to make the tax base more elastic, and to keep alcohol taxes in line with other states, *JOBS for Kentucky* includes a moderate increase in the wholesale tax rate, from 9 percent to 11 percent. This change becomes effective on June 1, 2005.

Consumers of alcoholic beverages will pay 1 to 2 cents more per bottle of beer, 13 cents more on an \$8 bottle of wine, and 16 cents more on a \$15 bottle of distilled spirits. Kentucky's alcoholic beverage prices will remain competitive compared to neighboring states.

**Real property
tax
modernization**

JOBS for Kentucky changes the procedure for setting the state real property tax rate by allowing the state to exclude "new property" from the 4 percent limit on the increase in revenues from the prior year. This change will make it identical to the existing process for local property tax rate setting.

The state real property tax rate has declined steadily from 1979 to 2005 as a result of the enactment of changes to KRS 132.020, generally known as House Bill 44. These provisions limit the state to a 4 percent increase per year in real property tax revenues, based on total assessment growth. The state rate was 31.5 cents per \$100 of assessed value in 1978 and decreased to 13.1 cents per \$100 of assessed value for 2004.

As a result, property tax receipts have declined steadily as a percentage of the General Fund from 10 percent in 1980 to the current level of about 6 percent.

The new rate setting methodology will allow the General Fund to benefit from new property growth in the same way as local governments, and will slow the 26-year decline of the state real property tax rate. Kentucky's state real property tax rate will remain relatively low compared to most other states. A study of

overall effective property tax rates, including all local levies, shows that Kentucky is competitive.

In addition, increased property tax collections will increase sheriffs' commissions.

Internal Revenue Code Update

Effective for tax years beginning on or after January 1, 2005, the "reference date" to the Internal Revenue Code is updated to December 31, 2004, with three exceptions noted below.

Kentucky uses the Internal Revenue Code and the federal income tax as the basis or 'beginning point' for Kentucky income taxes. By updating the reference date, Kentucky's tax laws conform more closely to federal laws, providing ease of filing for taxpayers and administering by the Department of Revenue. Exceptions to the code update:

- Depreciation calculations are based on the code in effect at December 31, 2001. This continues depreciation calculations without the bonus depreciation allowed after September 11, 2001.
- Allowances contained within the Military Family Tax Relief Act of 2003 are permitted at earlier dates if permitted by the federal government.
- Because Kentucky does not allow the deduction of state income taxes in determining Kentucky taxable income, the new federal option to deduct state and local sales taxes in lieu of state and local income taxes does not apply.

Modernization of income tax returns

Modernizing the administration of tax returns will make it easier for taxpayers to file their returns and increase compliance. Changes will include:

- Allowing general partnerships to file a composite return for electing nonresident individual partners and pay the tax computed at the top marginal rate;
- Clarifying the order for claiming the various credits available to individuals;
- Removing the requirement that the perjury declaration that must be executed for each tax return be written; and

- Annually publishing electronic versions of current withholding tables.

Many partnerships have partners that are not Kentucky residents, and the income from the partnership is the only Kentucky-source income for the partners. Allowing a single composite return to be filed by the partnership for all such filers is much easier on the partners and on the state of Kentucky, and encourages compliance by out-of-state filers.

Clarifying the order for claiming credits makes it easier for filers who have multiple credits to claim. The new language of this statute will correspond with the way the Department of Revenue currently allows credits.

With the advent of electronic filings and signatures, many items that used to require a manual signature are now legal and binding with an electronic signature. This change permits electronic tax return filers to affirm the correctness of their tax return with an electronic signature.

Internet Tax Freedom Act

The Internet Tax Nondiscrimination Act extends the original Internet Tax Freedom Act of 1998 and expands the definitions of access to include dial-up, DSL, cable modems and wireless Internet connections. The original Internet Tax Freedom Act prohibited states from taxing the provision of internet services unless the state was taxing them prior to the Act.

The first ban primarily covered dial-up access. The ban now is limited to three types of taxes: Internet access, double taxation of a product or service bought over the Internet, and discriminatory taxes that treat Internet purchases differently from other types of sales. The ban was not extended to affect Voice Over Internet Protocol (VOIP) technology.

JOBS for Kentucky revises the Kentucky tax code to conform to the federal Internet Tax Nondiscrimination Act.

Because of the expanded definitions of access, many telecommunications services that previously had been taxed will now become exempt due to their use by Internet service providers. If those providers pass the savings on to their customers, Internet services could become more affordable for some customers.

A stable pension exclusion

The pension exclusion in the individual income tax became effective in 1995 with an excluded amount of \$35,000. It has grown based on Consumer Price Index ("CPI") to the 2005 exclusion of \$41,110. In recent years, legislative and judicial action has expanded the amount of the exclusion and the number of pensioners who may exclude income.

The pension exclusion has been increasing steadily for the last several years. It is estimated that more than 98 percent of pensioners exclude all of their pension income from Kentucky tax. These pensioners receive more than 95 percent of pension income in the state.

JOBS for Kentucky freezes the pension exclusion at the current amount of \$41,110 annually per taxpayer and it will no longer be indexed. This change applies to tax periods beginning after December 31, 2005.

Several court decisions over the last decade have clarified that pension income must be treated equally if it comes from similar sources, but have not required exclusion or taxation.

In recent years, the Legislature has chosen to exempt progressively more pension income. With the aging of Kentucky's population, pension exclusions have become more significant and more expensive. By capping the exclusion at this level, the future income tax base is broadened.

Cost/benefit study of exemptions and exclusions in sales and use tax

JOBS for Kentucky calls for the Legislative Research Commission to conduct an in-depth cost/benefit analysis of all statutory exemptions and exclusions in the sales and use tax law. The study shall determine if the exemptions are resulting in a positive economic impact on the Commonwealth, and is due to be completed by December 1, 2006.

Kentucky enacted its current sales and use tax in 1960, applying the tax to the sale of all tangible personal property unless exempted by law, and did not tax the purchase of any services unless specified by law. At the time of enactment, exemptions from the tax included purchases of manufacturing machinery for new and expanded industry, coal purchased for generating electricity and other miscellaneous purchases.

According to the *Tax Expenditure Analysis for Fiscal Years 2004 – 2006* published by the Office of State Budget Director, the current sales and use tax code explicitly exempts more than 50 categories of goods, representing more than \$2.3 billion in tax expenditures.

These exemptions and exclusions have been added in piecemeal fashion since the inception of the tax, but have not been reviewed collectively to assess whether the various exemptions from tax have resulted in a net positive economic impact on the Commonwealth.

Since 1960, many product- and use-based exemptions have been enacted. The major categories of goods exempted from taxation and the year of the exemption are:

- Prescription medicines (1971);
- Food purchased for home consumption (1972); and
- Residential utilities (1979).

User-defined exemptions have been expanded over the years. Major beneficiaries of use-based exemptions or credits include:

- Farming and agriculture (1960-2003);
- Non-profit, educational, charitable and religious institutions (1976);
- Air carrier repair and replacement parts (1982); and
- Businesses and residents in Enterprise Zones (1992).

Exemptions and credits have grown until their estimated cost in fiscal year 2004 (\$2.27 billion) was almost as large as estimated revenues from the tax (\$2.40 billion).

Appendix A

HB 272 Fiscal Summary Adapted from KY General Assembly Summary

Tax Changes	FY 04	FY05	FY06	FY07	FY08	Total Impact
	(millions)					
Individual Income Taxes						
Expand low income tax credit	\$ -	\$ -	\$ (26.1)	\$ (26.7)	\$ (27.3)	
Stabilize the pension exclusion	\$ -	\$ -	\$ 0.8	\$ 4.0	\$ 9.8	
Health savings accounts	\$ -	\$ -	\$ (2.6)	\$ (3.0)	\$ (3.4)	
Adjust rates - current law w/ new 5.8% to 75K rate band	\$ -	\$ -	\$ (94.1)	\$ (65.0)	\$ (67.2)	
Postsecondary education tuition tax credit	\$ -	\$ -	\$ (16.0)	\$ (16.9)	\$ (17.9)	
Historic preservation tax credits	\$ -	\$ -	\$ (3.0)	\$ (3.0)	\$ (3.0)	
Income tax exclusion of state Phase II payments	\$ -	\$ (5.0)	\$ -	\$ -	\$ -	
Internal Revenue Code Update	\$ -	\$ -	\$ (0.3)	\$ (0.3)	\$ (0.3)	
Military family relief act	\$ -	\$ -	\$ (1.0)	\$ (1.0)	\$ (1.0)	
Net impact on individual income taxes	\$ -	\$ (5.0)	\$ (142.3)	\$ (111.9)	\$ (110.3)	\$ (369.5)
Business Taxes						
Limited liability entity inclusion	\$ -	\$ 21.3	\$ 100.7	\$ 103.1	\$ 105.4	
AMC with Alternate gross profits option	\$ -	\$ -	\$ 83.9	\$ 85.7	\$ 87.6	
Corporate license tax repeal	\$ -	\$ -	\$ (61.3)	\$ (202.1)	\$ (206.3)	
Rate Reduc. - Top Corp rate 7.0% for '05 and '06; 6.0% thereafter	\$ -	\$ (16.8)	\$ (45.5)	\$ (80.5)	\$ (82.2)	
Loophole closings	\$ -	\$ 13.9	\$ 75.0	\$ 59.0	\$ 61.2	
Kentucky clean coal incentives	\$ -	\$ -	\$ -	\$ -	\$ (4.2)	
Environmental stewardship tax credits	\$ -	\$ -	\$ -	\$ (5.0)	\$ (5.0)	
Biodiesel credits	\$ -	\$ -	\$ (1.5)	\$ (1.5)	\$ (1.5)	
Brownfields tax credits	\$ -	\$ -	\$ (1.0)	\$ (1.0)	\$ (1.0)	
Publicly traded partnership and affiliate exclusion	\$ -	\$ -	\$ (2.7)	\$ (2.7)	\$ (2.7)	
Reduce minimum tax to \$175	\$ -	\$ -	\$ (4.7)	\$ (4.7)	\$ (4.7)	
Recycling Credits	\$ -	\$ -	\$ -	\$ (7.5)	\$ (7.5)	
Net impact on business taxes	\$ -	\$ 18.4	\$ 142.9	\$ (57.2)	\$ (60.9)	\$ 43.2
Property Taxes						
Intangible property tax repeal	\$ -	\$ -	\$ -	\$ (36.0)	\$ (37.7)	
Real property tax adjustment	\$ -	\$ -	\$ 3.6	\$ 7.6	\$ 10.0	
Net impact on property taxes	\$ -	\$ -	\$ 3.6	\$ (28.4)	\$ (27.7)	\$ (52.5)
Sales Taxes						
Kentucky Enterprise Initiative	\$ -	\$ -	\$ (5.6)	\$ (30.4)	\$ (25.0)	
Sales tax nexus	\$ -	\$ -	\$ 1.0	\$ 1.0	\$ 1.0	
Equine breeder development funds*	\$ -	\$ -	\$ (15.0)	\$ (15.6)	\$ (16.2)	
Impact of Federal Internet Tax Freedom Act	\$ -	\$ -	\$ (9.4)	\$ (16.1)	\$ (16.3)	
Net impact on sales taxes	\$ -	\$ -	\$ (29.0)	\$ (61.1)	\$ (56.5)	\$ (146.6)
Alcohol Taxes						
Changing Wholesale Alcohol Tax from 9% to 11%	\$ -	\$ -	\$ 14.4	\$ 15.2	\$ 15.8	\$ 45.4
Tobacco Taxes						
Adding a 26 cent surtax, current vendor compensation law, assume payment plan for floor stock tax	\$ -	\$ 12.7	\$ 171.7	\$ 151.1	\$ 149.6	
Increased compensation for 6 months	\$ -	\$ -	\$ -	\$ (0.3)	\$ -	
Additional \$0.01 on cigarette tax (language in budget bill)*	\$ -	\$ -	\$ 4.3	\$ 4.3	\$ 4.3	
Other tobacco products	\$ -	\$ -	\$ 4.8	\$ 4.8	\$ 4.8	
Net impact on tobacco taxes	\$ -	\$ 12.7	\$ 180.8	\$ 159.9	\$ 158.7	\$ 512.1
Uniform excise tax on communications services	\$ -	\$ -	\$ 13.9	\$ 34.3	\$ 35.6	\$ 83.8
Lodging tax for tourism, meeting and convention development*	\$ -	\$ -	\$ 7.2	\$ 7.7	\$ 8.2	\$ 23.1
Corporation license tax reduction pending repeal (ITW)	\$ (26.6)	\$ (60.3)	\$ (54.2)	\$ -	\$ -	\$ (141.1)
Tax plan balance	\$ (26.6)	\$ (34.2)	\$ 137.3	\$ (41.5)	\$ (37.1)	\$ (2.1)

Note:

* Revenues dedicated to a restricted fund.

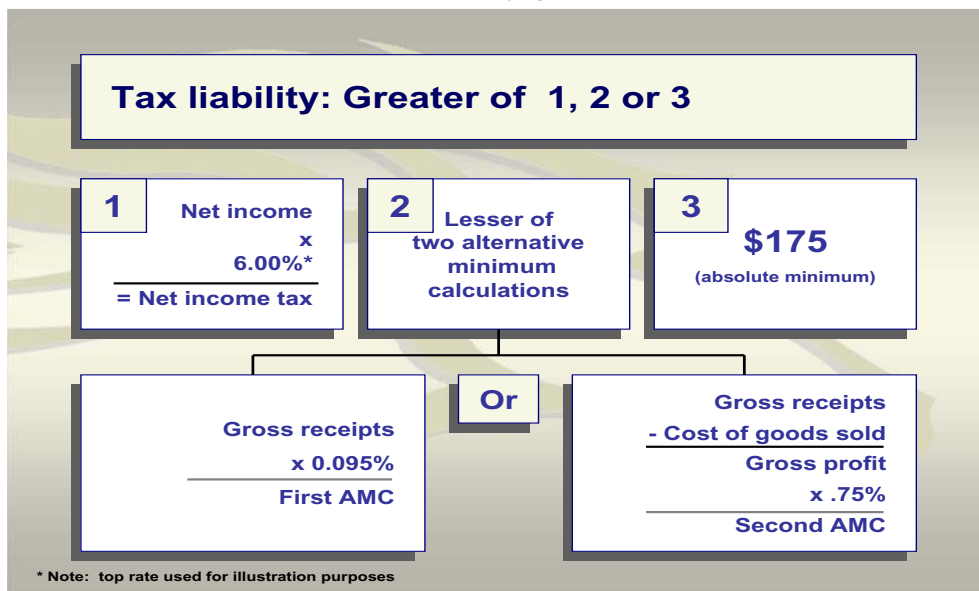
Expanded Corporation Income Tax, the AMC and Other Details of the Business Tax Changes

The corporation income tax is expanded to apply to all business entities with limited liability protection and to apply an alternative minimum calculation (AMC) based on Kentucky gross receipts or Kentucky gross profits. The tax due will be the greater of:

- A graduated 4 percent to 6 percent tax on net income;
- An alternative minimum calculation (AMC), which is the lesser of :
 - 9.5 cents per \$100 (.00095) of Kentucky gross receipts; or
 - 75 cents per \$100 (.0075) of Kentucky gross profits
- A minimum tax due of \$175

The current top corporation income tax rate is 8.25 percent. The top rate will be phased down to 7 percent effective 1/1/05 and then to 6 percent effective 1/1/07.

The accompanying chart contains information on the AMC and indicates the optional methods for calculation on either Kentucky gross receipts or profits.



The expanded corporation income tax applies to:

- Corporations (C-corporations & S-corporations)
- Limited liability companies (LLCs)
- Limited liability partnerships (LLPs)
- Limited partnerships (LPs)
- Real estate investment trusts
- Regulated investment companies
- Real estate mortgage investment conduits
- Financial Asset Securitization investment trusts

Publicly traded partnerships will be treated as general partnerships and are not included within the definition of a “corporation”. Publicly traded partnerships will continue to pass through their income to their partners and must continue to file a partnership return.

The following entities remain exempt from the tax:

- Financial institutions subject to the bank franchise tax
- Savings and loan associations
- Banks for cooperatives
- Production credit associations
- Insurance companies
- Corporations exempt from taxation under Section 501 of the Internal Revenue Code
- Religious, educational, charitable or like entities not organized or conducted for profit
- Contract printers under special circumstances
- General partnerships

Beginning January 1, 2005, the rate brackets for calculating the tax on net income are:

- 4 percent of the first \$50,000 of taxable net income;
- 5 percent of the next \$50,000 of taxable net income; and
- 7 percent of the taxable net income in excess of \$100,000.

For taxable years beginning on or after January 1, 2007, the rate brackets for calculating the tax on net income will be:

- 4 percent of the first \$50,000 of taxable net income;
- 5 percent of the next \$50,000 of taxable net income; and
- 6 percent of the taxable net income in excess of \$100,000.

The net income portion of the tax incorporates many of the provisions of the existing corporation income tax. The following changes from current income tax law apply to the expanded corporation income tax:

- A "doing business" nexus standard is used. This standard is broader than the physical presence nexus standard, which was only used by Kentucky.

- A consolidated return is mandatory for an affiliated group of business entities that has nexus with Kentucky, requiring a “nexus consolidated return.” Prior to enactment, taxpayers could elect to file a consolidated return.
- Certain deductions taken for payments made between affiliated companies for intellectual property, such as franchise fees and trademark fees, are no longer allowed. Some corporation income taxpayers reduce or eliminate taxable income in Kentucky by taking a substantial deduction for intellectual property. *JOBS for Kentucky* recognizes that certain expenses are legitimate but disallows abusive transactions. The provisions are similar to what is allowed in other states.

Certain deductions relating to transactions with one or more related members of an affiliated group will be disallowed unless:

1. The corporation and the related member are included in the same consolidated Kentucky corporation income tax for the relevant taxable year; or
 2. A disclosure is made and evidence provided to establish that the transaction was at arm’s length, that the payment made to a related member was subject to income tax in another jurisdiction and the related member has substantial business activities other than the management or ownership of intangible property; or
 3. The Department of Revenue and taxpayer agree in writing to an alternative method of apportionment.
- A common three-factor apportionment formula, with a double-weighted sales factor, is applied to the net income of those entities that are doing business within and without Kentucky.

Prior to enactment, some multi-state business entities used a single factor apportionment formula. An example of such a business entity is an LLC that is taxed as a partnership for Kentucky purposes.

A multi-state C-corporation presently apportions its income to Kentucky using the three-factor formula.

- Kentucky net operating losses may be carried forward and used as a deduction. Net operating loss carrybacks are no longer allowed.
- The recycling credit was revised to recapture the credit if the property is sold. Prior to *JOBS for Kentucky*, property that was subject to the recycling credit

could be sold without any recapture or loss of the credit to the original purchaser. Each subsequent purchaser could also apply for and claim the credit, if approved.

Therefore, the credit could be claimed by multiple purchasers of the same item, with no regard for how long each purchaser holds or owns the item. The intent of the recycling credit is to encourage conservation and recycling. Recapturing part of the credit if a purchaser disposes of an item prematurely assures that valid credits are allowed while protecting the system from abuse.

Finally, the recycling credit has been expanded to allow a taxpayer with a major recycling project an additional credit limited to 50 percent of the income tax liability in excess of the liability of the baseline tax liability or \$2.5 million, whichever is less. This new credit is limited to a period of 10 years commencing with the approval of the recycling credit application. To qualify, the major recycling project must:

- Invest more than \$10 million;
- Have more than 750 full-time employees with an average hourly wage of more than 300 percent of the federal minimum wage; and
- Have plant and equipment with a total cost of more than \$500 million.

The baseline tax liability is the tax liability of the taxpayer for the most recent tax year ending prior to January 1, 2005.

General partnerships remain pass-through entities and are not taxed at the entity level. The owners of these business entities will continue to be taxed as they were taxed, except that multi-state general partnerships now will use a three-factor formula to apportion their income to Kentucky.

Certain pass-through entities, such as S-corporations, limited liability companies, limited liability partnerships, and limited partnerships are taxed at the entity level. Whether income passes to their partners, members or shareholders depends upon the entity type of that partner, member or shareholder.

- For an individual partner, member or shareholder:
 - The income or the loss incurred at the entity level will be distributed to the individual.
 - A nonrefundable credit for the tax paid at the entity level will be provided to the individual based on their percentage of ownership.
 - The amount of the credit is equal to the individual's proportionate share of the tax due from the corporation prior to the application of any credits

taken by the corporation and reduced by the required minimum tax imposed by KRS 141.040(6).

- The credit will be limited to the amount of tax owed on the pass-through income.
- Unused credit will not carry forward.
- The application of the credit cannot reduce the tax payable to an amount less than would have been payable were the income from the taxable entity ignored.
- A refundable credit is provided for individual owners of pass-through entities for tax periods ending after January 1, 2005 and before January 1, 2007. The credit is based on the 1 percent difference between the top corporate rate and the top individual rate, and only applies when the corporate tax exceeds the individual tax on the same income. This is to assure that the individual owners and members of pass-through entities do not pay an increased amount of tax as the top corporation income tax rate is phased down.
- For a non-individual partner or member:
 - No income taxed at the entity level for partnerships or LLCs is distributed to the partner, member or shareholder.
 - No credit for the tax paid at the entity level is provided to the partner or member.
 - No part of the pass-through entity's net operating loss flows to the partner or member.

The tax base of the AMC calculated on Kentucky gross receipts includes, but is not limited to the following:

- Gross receipts from the sale of real property located in Kentucky;
- Gross receipts, less returns and allowances, from the sale of tangible personal property located in Kentucky that is shipped or delivered to a purchaser in Kentucky regardless of the f.o.b. point or other conditions of sale;
- Gross receipts, less returns and allowances, from the sale of tangible personal property shipped from outside of Kentucky and delivered to a purchaser in Kentucky regardless of the f.o.b. point or other conditions of sale;
- Gross receipts from the lease, rental or other use of real property located in Kentucky;

The tax base of the AMC calculated on Kentucky gross profits includes Kentucky gross receipts reduced by returns and allowances attributable to Kentucky gross receipts, less the "cost of goods sold" attributable to Kentucky gross receipts.

The term “cost of goods sold” is statutorily defined to mean the amount calculated using the same method specified by the Internal Revenue Service for the purpose of computing federal income tax. In determining cost of goods sold, labor costs are limited to direct labor that is incorporated into the product sold or is an integral part of the manufacturing process. Bulk delivery costs are included in the cost of goods sold only when the product is delivered to the consumer in bulk, the product requires specialized equipment that generally precludes commercial shipping, and the product is taxable under KRS 138.220.

Certain entities are exempt from the alternative minimum calculation. They are:

- Open-end registered investment companies;
- Public service companies subject to tax under KRS 136.120;
- Fluidized-bed energy production facilities; and
- Alcohol production facilities.

The alternative minimum calculation will not increase the amount of net operating loss carry forward utilized for a tax period.